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In the Supreme Court of the United States

OCTOBER TERM, 1953

No. 306

ESTATE OF LLOYD E. CRELLIN, DECEASED, CENTRAL BANK, A CORPORATION, EXECUTOR, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The Tax Court's opinion (R. 32-41) is reported in 17 T. C. 781. The opinion of the Court of Appeals (R. 64-68) is reported in 203 F. 2d 812.

JURISDICTION

The judgment of the Court of Appeals was entered on May 6, 1953, and a petition for rehearing was denied on June 3, 1953 (R. 69). The petition for a writ of certiorari was filed on August 31, 1953. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

In June, 1946, a personal holding corporation paid a dividend out of earnings to petitioners, the taxpayers, as stockholders of the corporation, who received the same without restriction. The dividend was declared by the directors under the belief that the corporate gains, unless distributed, would be subject to surtax. Later in the same year, learning that this opinion with respect to the federal tax law was erroneous, the directors passed a resolution which purported to rescind the dividend and directed that a demand be made upon the stockholders for return of the amounts which they had received. Taxpayers, between December 28 and 31, 1946, repaid to the corporation amounts equal to the dividend payments received in June.

The question presented is whether the action of the directors, in attempting to rescind the dividend and demanding the repayment by the stockholders in the year the dividend was declared and received, change the character of the dividend payments so as to authorize their exclusion from taxpayers' gross income or give rise to any allowable deduction?

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in the Appendix, *infra,* pp. 10-13.

STATEMENT

The facts as stipulated (R. 5-22) and as found by the courts below (R. 33-37, 64-65), may be summarized as follows:

Thomas Crellin Estate Company, usually referred to as "Crellin Company," is a California corporation. Crellin Company throughout 1946 was a personal holding corporation as defined by Section 501 of the Internal Revenue Code. During 1946 the stock of Crellin Company was owned equally by the five taxpayers, four of whom were also directors, the exception being the taxpayer, Estate of Lloyd E. Crellin, deceased. In addition, there was a fifth director, Crellin Fitzgerald. (R. 33-34.)

Before June 20, 1946, Crellin Company had on hand as long-term capital gains derived from the sale of securities and available for distribution as dividends approximately $100,000 in cash. The corporation's directors were aware of its status as a personal holding corporation, but nevertheless desired to have it reinvest the $100,000 unless distribution of that amount as dividends was necessary in order for the corporation to avoid payment of the personal holding corporation surtax on undistributed income. One of the directors, Crellin Fitzgerald, who was an attorney, consulted a certified public accountant and, relying upon what the accountant had informed him, advised the board of directors that if the capital gains were not distributed as a dividend, the corporation would be subject to the surtax, and that it was the board's duty to declare and make the distribution lest the corporation be subjected to such surtax. (R. 34-35.)

On June 20, 1946, the board of directors at a special meeting declared a dividend of $11.11 a share,

aggregating $99,990, payable immediately. In addition to Crellin Fitzgerald, taxpayers Mona L. Crellin, Ethel C. Hall and Jane C. Everett were present at the meeting. Thereafter, in June, 1946, the dividend was paid and each of the taxpayers received $19,998, which they deposited in their respective bank accounts. (R. 35.)

During the latter part of November, 1946, Crellin Fitzgerald learned for the first time that the advice he had received from the accountant and had passed on to the board of directors was erroneous and that distribution of the capital gains was not required in order to avoid the surtax. He notified the board of directors of his findings in this respect and suggested that the June resolution declaring the dividend be rescinded, that the stockholders be notified and the money paid to them under the dividend declaration be returned forthwith to the corporation. (R. 35-36.) At a special meeting of the board held on December 28, 1946, at which Crellin Fitzgerald and the four taxpayer-directors were present, the resolution of June 20, 1946, declaring the dividend was expressly "rescinded" (R. 36) and the directors further resolved that demand be made forthwith upon the shareholders "to whom purported dividends were paid," requiring that they return at once to the corporation the amounts which had been paid to them "under the aforesaid mistaken action of the board of directors" (R. 36-37).

The demand was made by the corporation for repayment of the dividend and each of the taxpay-

ers prior to December 31, 1946 repaid to the corporation $19,998, the amount that had been paid to each pursuant to the dividend declaration of June 20, 1946. (R. 37.)

The Commissioner determined that the $19,998, received by each of the taxpayers constituted gross income and that no reduction of gross income was allowable because of the subsequent repayment by each to the corporation of an equivalent amount. (R. 33, 37.)

The Tax Court sustained the deficiencies determined by the Commissioner (R. 42-46) for the reasons given in its opinion (R. 37-41) and the court below affirmed. (R. 64-68).

ARGUMENT

The court below correctly held that taxpayers were obliged to include in their personal income tax returns the amounts of the corporate dividends actually and unqualifiedly received by them in June from the corporation as its stockholders, which they voluntarily refunded to the corporation after its December 28th attempt to rescind the June dividend. There is no conflict of decision, and further review is not called for. [1]

[1] Taxpayers' assertion (Pet. 9-10, 13-16), made for the first time in their petition for a writ of certiorari, that the decision of the court below is in conflict with the decision of the Eighth Circuit in the case of *Stern-Slegman-Prins Co.* v. *Commissioner*, 79 F. 2d 289, is patently without substance. The *Stern-Slegman* case held merely that a corporation taxpayer could not deduct as a business expense an amount representing parts of salaries agreed to be paid, but not paid, to its officers, where the board of directors ordered the officers to donate the unpaid parts to capital surplus and the officers consented thereto. The rationale of the decision was that al-

Inclusion of the June dividend payment in taxpayers' income is plainly required by the Internal Revenue Code, and no provision of that Code authorized them to deduct their December remittances to the corporation. The cash distribution of its earnings made by Crellin Company in June, 1946 to taxpayers as its stockholders falls squarely within the definition of a taxable dividend set forth in the controlling statute and Treasury Regulations. See Internal Revenue Code, Sections 22(a) and 115(a), *infra,* pp. 10-11; Treasury Regulations 111, Section 29.115-1, *infra,* pp. 12-13. The cash was unqualifiedly paid to taxpayers out of corporate gains, and they received and deposited it in

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though the board of directors had no power to require the officers to donate a part of their salaries, it did have authority to reduce such salaries, and that the legal effect of the board's action was to reduce the salaries and eliminate altogether the corporation's obligation to pay the officers the amounts which, in form, they had consented to donate. Thus, the case turned solely on the conclusion that the corporation's obligation to its officers had been completely eliminated by the action of the board of directors. Manifestly, it does not follow from the conclusion that the corporation could not deduct the amount of an eliminated obligation from its gross income, that the officers would have the right to deduct it in their personal income tax returns. Moreover, the scope of the *Stern-Slegman* decision is made clear by the Eighth Circuit in its decision in *Leicht* v. *Commissioner,* 137 F. 2d 433, 435, a case similar in principle to the instant case, wherein it pointed out that its decision in the *Stern-Slegman* case to the effect that an extinguished obligation could not be deducted by a corporation, was in nowise inconsistent with its holding in the *Leicht* case that a salary once actually received by a taxpayer as an officer of a corporation in absolute right must be regarded as taxable income to him personally, even where he has chosen in the same tax year to make a voluntary refund of it to the corporation. Hence, the *Stern-Slegman* case presents no conflict, and the later decision of the Eighth Circuit in the *Leicht* case clearly supports the decision of the court below in the instant case.

their respective bank accounts under claim of right and without restriction of any kind (R. 35).

It is settled that where cash is delivered by its owner to a taxpayer in a manner which allows the recipient freedom to dispose of it at will, the taxpayer has derived income even though the cash may have been obtained by fraud or mistake and it may later be claimed that he is not entitled to retain the money and is liable to restore it equivalent. *North American Oil* v. *Burnet,* 286 U. S. 417, 424; *United States* v. *Lewis,* 340 U. S. 590, 591, rehearing denied, 341 U. S. 923; *Rutkin* v. *United States,* 343 U. S. 130, 137, rehearing denied, 343 U. S. 952; *Healy* v. *Commissioner,* 345 U. S. 278; *United States* v. *Lesoine,* 203 F. 2d 123 (C. A. 9). As those cases further indicate, where by reason of fraud or mistake or for some other ground, a taxpayer is obligated to pay out an equivalent of an amount thus originally received into gross income, he may usually claim an offsetting loss or expense deduction in the year of repayment; and if the compelled repayment occurs in the same year as the receipt, the transaction may, under some circumstances, conceivably be regarded as involving no increment to gross income, rather than an increment to gross income plus a deduction.

Here, however, contrary to taxpayers' contention (Pet. 26-29), they could not have been compelled to repay the dividends. Under the California statute a stockholder who receives a dividend without knowledge of facts indicating impropriety, even in the case of an illegal dividend

declared out of capital, cannot be compelled to refund it, whether the declaration was intentional or the consequence of mistake. Chase, California Civil Code (1945), Section 364, *infra*, p. 12; *Meyers* v. *El Tejon Oil and Refining Co.*, 29 Cal. 2d 184, 188-189; *Oilwell Etc. Co.* v. *Petroleum, Etc. Co.*, 64 Cal. App. 2d 367, 370-373; *United States* v. *Lesoine, supra*, p. 126, fn. 3. *A fortiori*, where as here, the dividend was properly declared,[2] the court below was plainly correct in holding that general provisions of the California Civil Code dealing with rescission of contracts, on the ground of mistake do not apply in view of the specific provisions of the same Code dealing with corporate dividends (R. 67). In any event, retention of a legal dividend by stockholders does not constitute unjust enrichment, since the stockholders are in reality the ultimate owners of the distributed fund. *Oilwell Etc. Co.* v. *Petroleum Etc. Co., supra*, at p. 373. This conclusion with respect to the law of California by the court below (R. 67-68) is the judgment of the circuit which includes California and in which a judge of experience in the jurisprudence of that state participated. See *Helvering* v. *Stuart*, 317 U. S. 154, 163, 164.

Taxpayers' contention that the decision below

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[2] The rule laid down by this Court in *McDonald, Receiver* v. *Williams*, 174 U.S. 397, is substantially the same. Again, since under California law directors' liability is limited to wilful or negligent declaration of improper dividends, the circumstance that three of the taxpayers, as directors, voted for the dividend here would give rise to no right of action against them. Chase, California Civil Code (1945), Section 363, Appendix, *infra*, pp. 11-12.

denies tax effect to the compromise of *bona fide* disputes (Pet. 16-26) is without merit. The Tax Court cases principally relied upon (Pet. 19, 24) are, as the Tax Court held (R. 40-41), without application to this case because of factual differences. The December payments to the corporation, of course, placed the taxpayers in a position to benefit taxwise by increasing the basis for the cost of their stock. However, to allow exclusion from gross income and cancellation of tax liability at a taxpayer's volition and without showing that a repayment falls within any deduction provision of the Internal Revenue Code would open the way to tax evasion schemes prejudicial to the revenue. *Leicht* v. *Commissioner, supra,* at p. 435; *Soreng* v. *Commissioner,* 158 F. 2d 340, 341 (C.A. 7).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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OCTOBER, 1953.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) [As amended by Sec. 166 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 201 (c) (5), section 204 (c) (11) and section 207 (a) (2) and (b) (3) (where the reference is to dividends of insurance companies paid to policy holders)) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close

of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * * *

(26 U.S.C. 1946 ed., Sec. 115.)

Chase, California Civil Code (1945):

SEC. 363. *Unlawful Dividends, Purchases and Distribution.*—Except as provided in this title, the directors of a corporation shall not authorize or ratify the purchase by it of its shares or declare or pay dividends or authorize or ratify the withdrawal or distribution of any part of its assets among its shareholders.

In case of any wilful or negligent violation of the provisions of this section, the directors under whose administration the same shall have happened, except those who may have caused their dissent therefrom to be entered on the minutes of the meeting at which such action was authorized, or who were not present at the time the board acted, shall be jointly and severally liable to the corporation or to its receiver, liquidator or trustee in bankruptcy for the benefit of the creditors of the corporation or any of them and of the shareholders and owners of shares at the time of such violation, for its debts and liabilities existing at the time of such violation, and for the full amount of any loss sustained by such holders and owners of shares other than shares upon which any such payment or distribution

was made, in any such case not exceeding the amount of such unlawful dividends, purchase price, withdrawal or other distribution.

* * * * *

SEC. 364. *Improper Dividends.* Any shareholder or owner of shares who receives any dividend, except a distribution covered by Section 402, Civil Code, not authorized by this title with knowledge of facts indicating the impropriety thereof shall be liable to the corporation or to its receiver, liquidator, or trustee in bankruptcy for the amount so received by him with interest thereon at 7 per cent per annum until paid. Any number of shareholders may be sued in the same action.

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.115-1. *Dividends.*—The term "dividend" for the purpose of chapter 1 * * * comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either—

(1) earnings or profits accumulated since February 28, 1913, or

(2) earnings or profits of the taxable year computed without regard to the amount of earnings or profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

* * * * *

A taxable distribution made by a corporation to its shareholders shall be included in the

gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands. * * *

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